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Social Policy and Macroeconomics

The Irish Experience

F. Desmond McCarthy

Many factors underlie the remarkable success of the Irish economy in the 1990s. This paper focuses on the role of the European Union, foreign direct investment, and a remarkable series of social pacts.

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Summary findings

The remarkable performance of the Irish economy in recent years has attracted much attention. Within a 10-year period the economy went from an 18 percent unemployment rate to nearly full employment, while the ratio of debt to GDP fell from 120 percent to less than 50 percent. Inevitably, this success was also accompanied by problems, as infrastructure came under increasing stress, environmental difficulties became more evident, and a changing social structure resulted in some groups becoming increasingly marginalized.

What worked and what did not? In particular, are there lessons that may be relevant for other countries facing similar difficulties, especially in Asia and Latin America?

McCarthy focuses on three features of Ireland's economic achievements. Two of these features are external: the opening to Europe and the role of foreign direct investment. The third and perhaps most "exportable" feature is domestic: the role of a social pact. This pact was initially between employers, trade unions, and the government. Subsequent pacts were extended to include a variety of other groups. McCarthy discusses the far-reaching impact of this series of pacts on health, poverty, employment, education, and social welfare.

Ireland now faces a number of challenges, including the slowdown in the global economy, a fall in resource transfers from the European Union, and the potential effects of the entry into the EU of Hungary and Poland.

This paper—a product of Development Dialogue on Values and Ethics, External Affairs, with support under the ASEM Trust Fund—is part of a larger effort in the Bank to explore and present European social policy experience relevant for the East Asia post crisis. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Julie Turner, room U11-1109, telephone 202-458-1767, fax 202-522-7524, email address jturner@worldbank.org. Policy Research Working Papers are also posted on the Web at http://econ.worldbank.org. The author may be contacted at fmccarthy@worldbank.org. December 2001. (27 pages)

Social Policy and Macroeconomics: The Irish Experience

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1. Introduction

Economic development has many diverse features. In recent years these range from the remarkable growth enjoyed by the United States in the 1990s, to the turbulence in Asia and Latin America and the dismal performance in much of Africa. As policymakers search, yet again, for better approaches, any success story attracts a great deal of attention. Inevitably the remarkable achievement of the Irish economy in recent years attracts such attention. Selected economic data are given in Table 1. It is notable, for instance that within a ten year period the unemployment level went from 18 percent to near full employment (Figure 1), while at the same time the debt to GDP ratio went from 120 percent to less than 50 percent (Figure 2). Inevitably this success was accompanied by a number of problems, as infrastructure became more stressed, environmental difficulties became more evident, and a changing social structure meant that some groups became increasingly marginalized. What worked and what did not work? Are there lessons to be garnered from this experience?[1]

The next section of this paper provides a brief background on the economy and how the need for change became increasingly evident in the 1980s. Although there were many influences at work, we choose to focus on three: two external and one domestic. Even with the benefit of hindsight it is not clear how important each of these was in shaping the development process. In section three we discuss two of the major external features: opening to Europe and the role of foreign direct investment. In section four we discuss a major domestic feature—the social pact and the concomitant macro stability. Section five goes on to discuss some of the results of this first social pact–primarily the impact on exports and the relatively small, at that stage, impact on employment. In section six we discuss the more far-reaching outcome of the series of pacts on employment, social welfare, health and education and poverty. Section seven offers some of the preliminary lessons that may be relevant for other countries facing similar problems, especially the Asian and Latin American developing countries.

[1] The Irish experience is discussed in a variety of sources, including Nolan and others (2000), OECD Economic Surveys: Ireland (1999), Economic Intelligence Unit, Country Report-Ireland (2001), Sweeney(1999)

Table 1. Selected Economic Indicators

	1	2	3	4	5	6	7	8	9	10
								Current government exp. (percent of GNP)		
Year	*GDP growth*	*Unemployment (% total labor force)*	*Gross general gov. (Debt/GDP)*	*Fiscal deficit (%GDP)*	*Current account (%GDP)*	*Inflation rate (CPI)*	*Real exch. rate (earnings)*	*Education*	*Health*	*Social Security*
1981	3.33	9.9	78	−13.7	−14.6	20.3	91	6.0	7.3	10.4
1982	2.28	11.4	87.2	−13.3	−10.9	17.2	97	6.3	7.4	12.6
1983	−0.24	14.0	97.4	−10.9	−7.5	10.5	96	6.2	7.4	13.3
1984	4.35	15.6	102.5	−10.2	−6.6	8.6	96	6.2	7.1	13.6
1985	3.09	17.4	104	−10.3	−4.8	5.4	98	6.2	7.2	13.8
1986	−0.43	17.4	114.5	−10.3	−4.2	3.8	104	6.2	7.0	14.1
1987	4.66	16.9	116.8	−8.2	−1.3	3.2	102	6.3	6.6	13.6
1988	5.22	16.3	112.4	−4.3	−1.2	2.1	99	5.8	6.2	12.9
1989	5.81	15	101.8	−1.7	−2.9	4.0	96	5.6	6.0	11.9
1990	8.47	12.9	96.0	−2.2	−1.8	3.3	100	5.3	6.3	11.3
1991	1.93	14.7	95.3	−2.3	−0.4	3.2	98	5.4	6.7	12.0
1992	3.34	15.1	92.3	−2.4	0.4	3.0	100	5.8	7.0	12.6
1993	2.69	15.7	96.3	−2.3	3.7	1.4	94	5.9	7.1	12.2
1994	5.76	14.7	88.2	−1.7	2.9	2.4	92	5.9	7.0	11.7
1995	9.74	12.2	78.9	−2.2	2.8	2.5	93	5.5	6.8	11.7
1996	7.69	11.9	74.1	−0.6	3.3	1.7	95	5.3	6.5	10.7
1997	10.74	10.3	65.1	0.8	3.1	1.5	95	5.1	6.6	9.8
1998	8.56	7.8	55.0	2.1	0.9	2.4	92	4.9	6.5	9.0
1999	9.82	5.7	50.1	1.9	0.4	1.6	91	4.9	6.7	8.4
2000	11	4.3	39.1	4.7	−1.7	5.7	88			

Note: Column 4: Before 1987, Exchequer borrowing requirement (-); from 1987, General Government Surplus (EU definition). (In 1987 EBR was almost exactly the same as GGS at 8.1.) Column 5: NIE 2000. Column 7: Based on hourly earnings. Source: Department of Finance (to 1990); Central Bank of Ireland. Columns 8-10: CSO: Social Protection Accounts: Expenditure of Central and Local Governments.

Figure 1. GDP Growth, Unemployment Percent Total Labor Force, 1980-2000

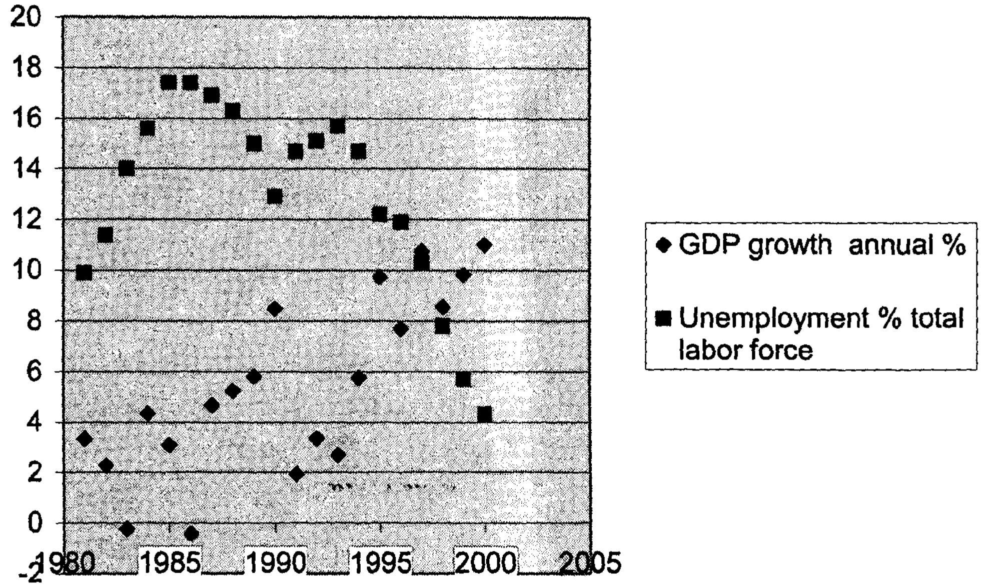
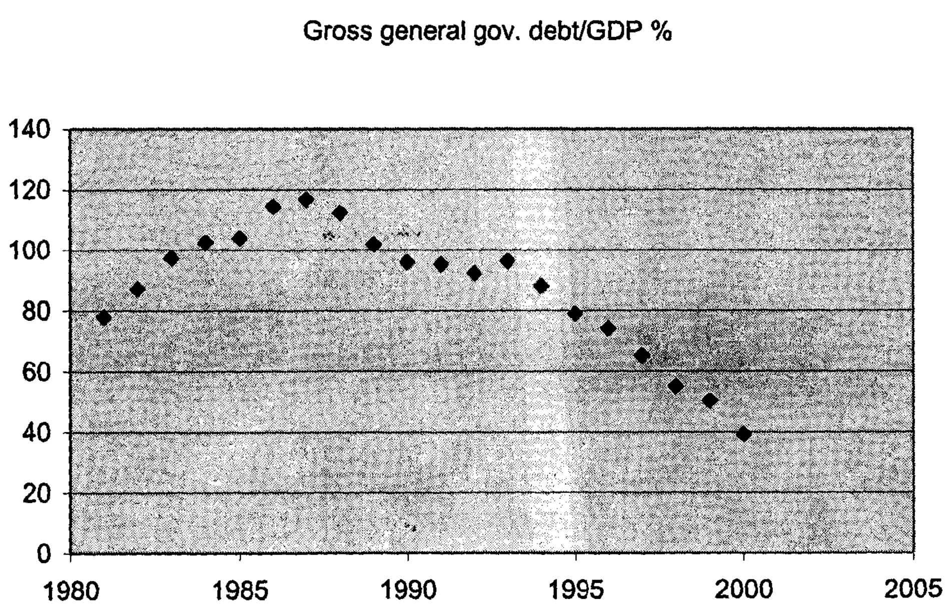


Figure 2. Debt/GDP Percent, 1980-2000



2. Background

2.1 Dismal Performance

In the early part of the century Irish living standards were judged comparable to those of north European economies such as Norway and Finland (O Grada 2001), with per capita levels of about 50 per cent of the UK, but greater than countries such as Italy, Greece and Portugal, and were converging toward levels in Britain and most of Western Europe (Lee 1989). Following independence in the 1920s Ireland's relative position began to slip. Explanations offered for this dismal economic record include institutional and cultural constraints on performance (Lee ibid); the policy of import-substituting industrialization, pursued by the Fianna Fail Party after coming to power in 1932; and more recently the effect of the fiscal response to the oil crises of the 1970s (O Grada and O'Rourke (1995). For most of the twentieth century, even well into the late-1980s, the economic record was a rather dismal one. The seemingly chronic unemployment situation led to a large flow of emigrants and dampened any form of entrepreneurial activity. Ironically the civil service was a beneficiary as this offered one of the main possibilities of employment for those who chose not to emigrate. Entry was by an extremely competitive exam, and this led to a stable and technically competent cadre, who later played an important role in implementing the policy initiatives that followed.

The cultural ethos of Ireland meant that during these economically dismal times, there had always been an ongoing empathy with the less fortunate; even during the toughest time there was a general willingness to ensure they had some, albeit small, social benefits for unemployment, health and education. Stipends were available to the unemployed. Virtually all had access to some minimum health care. Education, at least up to the primary school level was available to all, and was supported by a school network that ensured that almost all potential students were within walking distance of a school.

2.2 Need for Change

The overall approach to development sought to reflect to some extent the cultural and social values of the society, but any significant improvements were largely stymied by a seemingly ongoing chronic economic situation. The immediate impact of the two oil shocks of the 1970s, further aggravated in the early 1980s by the high interest rates resulting from the Volker anti-inflationary policies, led to further difficulty for the Irish economy. By the mid-1980s the situation had reached crisis proportions. In spite of ongoing emigration, unemployment levels were around 18 percent by 1987, while the external debt-to-GDP ratio was close to 120 percent. There was even some discussion about a possible default. There was an increasing awareness that much of the population had reached the limits of their tolerance. A broad consensus emerged among all major players that the situation needed to be addressed, and in particular public finances needed to be sorted out. In 1987, the recently elected Prime Minister, C. Haughey, pushed through a set of dramatic actions, by using all political means to win support for reform measures to address the situation. The opposition showed political maturity by supporting the required cuts, even at their own political cost. It was evident that the fiscal situation needed to be addressed as soon as possible, but there was also a serious unemployment problem, a strong resurgence of emigration, poor economic growth and generally deteriorating living standards.[2] A centerpiece of the reform was a social pact, Program for National Recovery (1987–1990), which essentially removed most of the rancor from the macro debate and resulted in stable labor relations.

3. The Setting for Policy Change

3.1 Change

In addition to the social pact, and the associated improvement, several other factors played salient roles. These included the openness to Europe, the break with Sterling, the role of foreign direct investment (FDI), changes in technology, industrial organization, and an increased awareness of the role of information. Because these changes were contemporaneous, their specific impacts are quite difficult to unravel.

On the external side Ireland became a member of the European Community in 1973. This led to a broader free trade regime[3] and introduced significant changes in benefits especially to the agriculture sector. Perhaps even more significant, it heralded a change in behavior and perceptions. Previously the United Kingdom and the United States tended to have a dominant rôle, not only in economic terms but also in terms of how people framed their view of the world. Ireland had a long tradition of emigration and cultural exchanges to both these countries, while economic policy was heavily influenced

[2] It is interesting to note that the Netherlands faced a crisis in 1982 that had many features similar to the Irish situation. They managed to address many of their problems and transform their economy by a set of policies that combined fiscal consolidation, reform of benefits programs, wage moderation. This was also done through extensive consultation and cooperation with social partners. It is notable that the problem of long-term unemployment remains a challenge. See Watson et al.(1999) for further discussion

[3] There was already free trade vis-à-vis Britain from the mid-1960s.

by the United Kingdom, the dominant trading partner. The increasing importance of the European dimension led to a new awakening of a more global nature. The younger generation especially, began to look to Europe, and education became more cosmopolitan. At a different level, policymakers were more aware of the de facto constraints of Europe and the associated rewards for prudent action. Foreign business saw the advantages of an English-speaking, well-educated populace with ready access to the large European market, and the broad institutional stability provided by the European umbrella. This institutional framework helped foster more transparent and responsible behavior, supported by better monitoring and accountability, especially in the use of public funds. As this virtuous cycle got underway there was a steady increase in the overall entrepreneurial spirit and a more positive "can do " attitude. First, we discuss briefly some of the steps that led to the opening to Europe.

3.2. Opening to Europe

The direct implications of joining the European Economic Community in 1973 provided policy makers with clear markers to guide the economy along a more efficient and less distorted path. While there were changes in many aspects of the economy some of the more substantial were in two areas: trade and the agriculture sector.

Trade. Ireland became committed to joining a customs union with common external barriers and, by 1977, had no internal trading barriers. Under the new free trade regime Ireland's exports grew rapidly from 38 percent of GDP in 1973, to 62 percent by 1991, and to 86 percent by 1999. At the same time the composition and direction of trade moved from exports of primary goods (mainly agricultural) to manufactures.[4] The direction of trade moved away from the traditional dominant share of the United Kingdom as shown in Table 2. The share for the European Union (EU) remained stable at close to 40 percent while that for NAFTA.increased substantially from 9.1 percent in 1987 to 17.9 in 2000.

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[4] In 1987 agricultural produce was 17.5 percent of exports. This fell to 4.8 percent in 2000. Industrial produce went from 80.2 percent to 92.8 over the same period.

Table 2. Exports by Area
(percentage)

Period	*Great Britain and Northern Ireland*	*Other EU*	*NAFTA*	*ROW*	*Total*
1987	34.2	39.3	9.1	17.5	100
2000	22.2	39.8	17.9	20.1	100

Source: Trade Statistics, Central Statistics Office.

Agriculture. Ireland benefited greatly from transfers through the Common Agricultural Policy (CAP). This policy sought to support agricultural goods sold on the world markets by maintaining them above world prices through closed markets. The consumers paid the cost. Ireland, being a net exporter of farm goods, was a major beneficiary. There are various estimates of the size of this transfer but it typically represented around 2 to 6 percent of GNP per annum.[5] In 1981 agriculture accounted for about 14.7 percent of employment. As the economy developed this share fell steadily to 9 percent in 2000. The numbers employed in agriculture fell from 167,000 to 117,000 over this period. While one may argue about how appropriate the structural change was in agriculture, the CAP transfers did provide a cushion during this transition. It remains an open question whether providing a protective shield from the global competitive forces is a good idea for the longer term. Many countries have also experienced the decreasing importance of agriculture as an employment source. What is notable about the Irish experience is that the sharp drop in agricultural employment was not accompanied by major social unrest. Much of the surplus labor was absorbed into other sectors. For most of the post 1973 period the other sectors were in the UK and US up to 1990. In the nineties this was facilitated by having strong growth in other sectors, especially the service sector, while at the same time support was provided by an active policy to address unemployment.

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[5] Matthews (1994).

In addition Ireland also received resources from three structural funds, the European Regional Development Fund (ERDF), designed to assist development of the poorer regions; the European Social Fund (ESF), and the Guidance Section of the CAP funds (EAGGF). A fourth fund, the Cohesion Fund directed at transport infrastructure was established under the Maastricht treaty (1993). While some of these flows were offset by government contributions the net receipts are estimated at around 3 percent of GNP.

The broad objective of the structural funds was to enable Ireland to compete unaided in the Single Market. Initially the allocation of these funds had varying degrees of success, but over time a number of measures contributed to improved effectiveness of these funds. They were targeted at the development of physical and social infrastructure. For instance Community Support Framework (CSF) for the period 1994–99 sought to allocate funds to priority areas in industry and human resources with an emphasis on transport and tourism. This framework was integrated with domestic policy and resources. There has been considerable analysis of the performance achieved under these funds. In a detailed mid-year evaluation of the CSF 1994-9 Honohan (1997) chose to dwell on a number of problem areas and suggested recommendations for change. For instance he identified the need for upgrading certain types of public infrastructure, such as non-urban roads and urban public transport to meet the needs of the rapid economic growth. He also felt the need to better focus the active labor policy on those in need. Sabel (1996) also reviews many of the institutional innovations introduced by the Irish government. His focus is more on how they sought to address issues of social exclusion in a more flexible, decentralized and participative way. He identifies the important role to be played by local partnerships in reforming public administration. While he praises the innovative dimension of these initiatives he raises some question about the need to build stable institutions to sustain them, especially as the CSF resources are likely to diminish in the near future.

The transfer of funds made a substantial contribution, but some of the benefits of the EU association have come in a more indirect manner. The Maastricht Treaty that became effective in 1993 provided a clear outline for achieving Economic and Monetary Union (EMU) by the end of the century. This treaty came after the stabilization but it helped remove (or at least sharply reduced) the possibility of inappropriate fiscal expansionary experiments from the repertoire of policymakers by future governments.

Ireland joined the European Monetary System (EMS) in 1979. The initial expectation was that Ireland would benefit from the low inflation Deutsche mark. A series of devaluations took place, on average about one a year, with larger ones in 1983, 1986, and 1992. For a small open economy like Ireland exchange rate policy is a major concern as one seeks to balance the stability of a pegged system with the volatility of a float. The Balassa-Samuelson dilemma of pegging a high to a low growth economy is also likely to create some difficulty through inflation on non-tradables Presently the European Council has established a European Central Bank and by 2002 the EMU will be completed when the euro enters circulation. At that point Ireland will have as much direct control over fiscal and monetary policy. This will create another set of challenges not only in the economic sphere but also possibly politically, as some measure of sovereignty is lost. In parallel with the opening to Europe was the increasing role to be played by Foreign Direct Investment (FDI)

3.3 Foreign Direct Investment (FDI)

As the stabilization measures progressed it became evident that additional action was needed to stimulate economic growth and address the unemployment problem. Given the large external debt at the time (120 percent of GDP in 1987), it was evident that the export sector needed to play a larger role. This in turn required a competitive economy supported by adequate investment both in quantity and quality. With the macro situation essentially out of the debate and stable labor relations in place, the focus then turned to growth. The domestic economy after years of indifferent performance was largely ill prepared to face international competition; much of the public sector had structural difficulties in terms of communications, transport, and power. The Industrial Development Authority (IDA), which had considerable experience in attracting foreign firms but a mixed record in earlier years, sought to attract dynamic American firms. A well-educated work force, English-speaking, good labor relations and access to the large European market was a major attraction, along with a low corporate tax rate, 10 percent after 1979.[6] However the experience in the 1970s and early 1980s indicated that although some foreign firms took advantage of the various enticements, it did not lead to a strong impact on the economy. Linkages to the rest of the economy were often weak, and some of these companies tended to gravitate toward more favorable offers as they appeared in other countries.

In the late 1980s a number of factors changed at the global level. Major changes in industrial structure[7] occurred as multinationals moved from the mass production model

[6] The European Commission viewed the special rate of taxation as a state subsidy. The government is now committed to having a standard rate of corporate taxation at 12.5 percent by 2003.

[7] For an excellent discussion see Sabel (1996).

towards the Japanese style of greater flexibility. This in turn led to foreign branches of these companies moving away from relatively insulated units, and toward a more flexible model and one more integrated with the local economy. At the same time the companies of the "new" economy were intrinsically more flexible. In particular new technology reduced transport and communications costs, so that the geographic disadvantage of being an island economy was sharply reduced. The IDA strategy was quick to perceive these new trends, and was able to attract a number of flagship companies enjoying rapid growth at the global level, such Intel and Microsoft. At the same time the IDA offered a good platform for many of the large chemical and pharmaceutical multinationals. While the domestic companies were somewhat slower in reacting to the improved economic conditions, these multinationals were able to produce a dramatic increase in exports. By 1990 exports showed an annual increase of 8 percent.[8]

During the initial three-year pact the strong increase in GDP and especially in exports was not accompanied by serious inroads into the unemployment problem. There was some discussion about these multinationals producing growth without employment, while other critics felt they were simply using transfer pricing to take advantage of the favorable corporate tax rates. However these new companies were building linkages with domestic suppliers, and this was to become increasingly evident during the next few years. Given the small size of the domestic market, the output of these companies was heavily dependent on external demand, and therefore sensitive to the health of the global economy. In a favorable global climate, especially for the technology sector, this FDI strategy has a lot to offer. In addition to the direct impact on employment and exports, it helped foster links to many domestic companies and also strengthened entrepreneurial skills. In the event of a less favorable global climate, however, especially for the technology sector, policymakers will face serious challenges. While one can expect a long term benefit from gains in knowledge and entrepreneurial externalities, the fact remains that many of the companies will continue to seek market advantages wherever they occur and may be foot loose. The feature of greater links to the domestic economy may turn out to be a disadvantage in any dramatic economic downturn. In this context it would be helpful to examine to what extent the FDI success is driven by a favorable tax regime and to what extent other features such as access to Europe, English speaking well educated workforce play a role.

4. Social Pact

[8] The volume index was to quadruple from 1990 to 2000, an average annual growth rate of 15 percent.

4.1 *Program for National Recovery*

In order to understand the setting for the social pact of 1987 and the five subsequent versions one needs an appreciation of many domestic factors. While one must not underestimate the achievement of the social pact, the timing was particularly fortuitous.[9] The major political parties were willing to support the necessary measures. The global economy was entering a relatively buoyant phase so that risk taking, in the choice of industry for supports for instance, was well rewarded. Historically trade-union-management relations in Ireland had been often adversarial. However in the late 1980s, the weak position of the economy and the increasing role of some forward-thinking union leaders facilitated a tripartite agreement between unions, employers, and government. [10] The **Program for National Recovery (PNR)** was able to draw on analysis from the Strategy for Development (1986) produced by the National Economic and Social Council (NESC).[11] The NESC is an advisory body that analyses policy issues and seeks consensus. Its members include representatives of the employers, trade unions, agriculture sector and senior civil servants. A number of authors have written on the roots of this plan. [12] Much of this work had been carried out during the tenure of the previous government, and thus was at least implicitly in line with the policy objectives of the then opposition party. This allowed for broad political support. The agreement covered a wide array of issues of importance to all groups. A key outcome was to establish a formula for moderate wage agreements over the next three years, which provided for modest annual increases and helped ensure relatively peaceful labor relations over that period. In return the government agreed to reform income tax in favor of employees. The agreement also ensured that welfare would not have to bear most of the brunt of the fiscal retrenchment.[13] In fact welfare spending did show a modest absolute increase but not as a

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[9] There are some who would argue that it was only when the situation became truly desperate that a consensus evolved and so it was endogeneous to the crisis.

[10] Over time the partnership was widened to include representatives of voluntary and community organizations. Partnership 2000 involved representatives of the unemployed, women's groups and others addressing social exclusion.

[11] This was to be the first of five subsequent agreements. Each social partnership agreement was preceded by a NESC Strategy report. These set out the shared perspective of the social partners on the parameters within which a new program should be negotiated (see O'Donnell in Wallace 2001).

[12] O'Donnell (2001) suggests that Ireland, together with some other small European member states are inventing a new post-corporatist form of macroeconomic concertation and structural reform, which differs from the dominant continental European models-German, French and Scandinavian.

[13] The Irish social welfare system does not lend itself to easy categorization. Much of the features

share of the economy. The program was to be monitored by a Central Review Committee, with all key questions subject to consultation between the partners. Even with the agreement in place, the fiscal retrenchment required strong backing from the highest levels of government. The fiscal crisis and its resolution was a key part of the social agreement. This is discussed in detail by Honohan (1998).

4.2 Fiscal Policy

In 1986 the current budget deficit was 7.9 percent of GDP while the public sector borrowing requirement (PSBR) was 14.2 percent of GDP. By 1990 the corresponding figures had dropped to 0.6 and 2.8, respectively.[14] During these years total revenue share went from 37.9 to 34.5 percent of GNP while spending fell dramatically from 45.8 to 35.1 percent of GNP. Given the rapid increase in GNP during this period the revenue did not change much in absolute terms but the spending cuts were substantial. Why this was achieved so quickly after many years of failed adjustment approaches? Although Honohan (1998) reviews many explanations, no single theory seems to offer a convincing explanation.[15] However a decisive explanation would include political determination together with some measure of good luck. Fiscal policy included a freeze on recruitment, an early retirement scheme, cutbacks and postponements of public infrastructure, including public housing. All increases were essentially denied and demands from local political groups were resisted. Clear political backing allowed the Finance Minister, Ray MacSharry to restrain public spending, which wiped out the fiscal deficit in three years. Political restraints were further supported by instructions to all government departments to hold the line on expenditures. The relative strength of the civil service, and especially the senior civil servants in these departments, helped ensure the success of this effort. The fiscal effort was given further support when a tax amnesty in 1988 yielded results above most expectations. This amnesty was backed by credible threats, so that not only the

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followed from that of the UK and so may be loosely termed liberal. In the mid-1990s expenditure on social insurance plus social assistance at about 10 percent of GDP meant that Ireland was among the lowest in Europe. See Callan and Nolan (2000). The other major welfare expenditures were health and education which typically added a further 10 percent (see Table 1 for yearly figures).

[14] Department of Finance.

[15] He does place some credence on the lower opportunity cost during prolonged recession for business to restructure their activity. He also notes the importance of becoming competitive, underpinned by wage restraint and favorable exchange rate and having a favorable world demand situation. Thus the recovery was export led, followed by consumption and investment. These help explain investment and growth but not the reduction in the deficit.

immediate revenue improved, but it also helped ensure improved compliance in future years.

Structural funds from the EU averaged 1.5 percent of GNP in the 1980s, and increased to 2.6 percent in the 1990s. These were used largely for infrastructure investment and resumption of projects deferred during the fiscal crunch.

4.3 Exchange Rate

Fiscal balance needed to be complemented with an appropriate exchange rate. Ireland joined the EMS in 1979. The real exchange rate, as shown in Table 1, experienced an appreciation of about 1 percent per year against other countries in the system. This was due to a higher rate of wage and price inflation in Ireland. This upward trend slowed in the late 1980s due to domestic wage restraint. The real exchange rate remained competitive until 1992 (see Table 1) when the Bank of England withdrew sterling from the ERM and there was a subsequent fall of 15 percent by sterling on the foreign exchange market. This resulted in overvaluation of the Irish pound relative to sterling with loss of competitiveness for trade with the UK. After expensive intervention the Central Bank devalued by 10 percent in early 1993. For the rest of the 1990s Ireland was able to take advantage of the flexibility of the ERM to maintain competitiveness. But with the advent of the EMU, room for adjustment becomes much tighter. The successful fiscal correction, competitive real exchange rare and a concomitant fall in interest rates provided a necessary macro basis for growth. These achievements were to be locked in by the adoption of the Maastricht criteria from 1992 onward. The fiscal adjustment was quite painful. Many countries have also undergone similar adjustments but with indifferent results. In Ireland the broad political support, the EU institutional umbrella lent credibility and of course the good fortune of a strong global economy led to dramatic results.

5. Early Results

5.1 First Results

The immediate results were quite remarkable. By 1990 the GDP growth rate reached 8.5 percent. The primary deficit[16] of 1.8 percent of GNP in 1986 shifted to a surplus of 6.9 percent of GNP in 1990. Exports increased by 48 percent (in volume

[16] Department of Finance. The primary deficit is the exchequer borrowing requirement exclusive of interest payment.

terms) over the same period. As the virtuous cycle ensued, confidence in the overall policy approach began to increase and the tripartite agreement was followed by a series of three-year agreements: (1) the Program for Economic and Social Progress (PESP) 1990–93, (2) the Program for Competitiveness and Work (PCW) 1994–96, (3) the Partnership 2000, 1997-2000, and (4) the latest, the Program for Prosperity and Fairness (PPF), 2000. In each of these agreements increasing attention was devoted to the broader issues of distribution and structural reform. In the early 1990s unemployment and emigration were dominant concerns. As economic gains continued through the 1990s the agreements placed increasing emphasis on social cohesion, regional development, and poverty.

5.2 Unemployment

During the first plan period the great improvements in most aspects of the economy were not matched by similar progress to reduce unemployment, which only began after 1993. There has been considerable analysis of what exactly was achieved during this first PNR. Various experts tend to highlight different features. McAleese (1997) places emphasis on the improvement in competitiveness of the overall economy. He notes the role of the move to free trade, macro stability, acceptance of competition and the market system and growth that ensued, paradoxically through reductions in the fiscal deficit. [17] A compendium of papers by distinguished economists commissioned by Gray (1997) offered a variety of explanations [18]. The sheer variety of these explanations is perhaps testament to the lack of any dominant theory, but it also emphasizes the importance of Ireland specific factors with which many of the participants may not have been particularly familiar. O'Donnell (1998), from a somewhat different perspective, also notes the importance of achieving a competitive advantage but places considerable emphasis on social inclusion. His analysis of the Irish Social Partnership suggests that it was not a bargaining solution between the partners but rather "a shared understanding of the problems facing the Irish economy and society and the main lines of policy required to address them." He highlights the change in institutions, that facilitated a realistic discussion of change rather than a political system that tended to clientelism; a more

[17] For a more complete discussion of how tighter fiscal policy can produce a virtuous circle and lead to growth see McAleese (2001). See also Barry and Devereux (1995) who suggest that other effects, such as the confidence boosting relation with the German economy may have had an important role.

[18] These included Krugman's view of the importance of technological changes in transport and communications, Sachs's orthodox view with emphasis on the role of FDI, Vickers emphasis on the role of privatizing state monopolies and ensuring adequate competition.

forward-looking trade union movement; enterprises that came to realize that they could no longer count on direct and indirect protection. Sabel (1996) also notes the need for an open, competitive economy. He also highlights the important role played by creation of more locally based partnerships to address issues of social exclusion and unemployment in a more flexible, decentralized and participative way.

By 1990 there was a broad acceptance by all groups of the need to address the problem of unemployment and especially long-term unemployment. In the 1970s and especially in the early 1980s, as protection was removed from domestic industry and adjustment to the European market progressed, the international market became more competitive. As a result, many of the "traditional " Irish industries suffered. The auto, textile, and leather goods sectors declined precipitously, and at least initially, employment losses were not offset by the more buoyant chemical, pharmaceutical, and electronic sectors, which tended to be more capital intensive. The situation was further compounded in the 1980s by the sluggish British and U.S. economies, which were the traditional destinations for Irish emigration. The result was a dramatic rise in unemployment to around 17.4 percent in 1986. Even by 1993 this level had changed little. Even more disconcerting was the level among the long-term (more than 12 months) unemployed. Their share of the total went from about one-third to half of the total during this period. This long-term rate was particularly worrisome as this group also had an associated problem of poverty and social exclusion. Many measures were adopted to address these problems. Since 1993 the unemployment situation has improved remarkably as the unemployment rate had dropped to 3.9 percent by the 4th quarter of 2000. At the same time the size of the labor force increased to 1.8 million from 1.3 million in 1987. There are a number of reasons to account for this on both the supply and demand side. These include

- the rapid increase in participation rates especially among females,
- the extremely high economic growth rates and the gradual spread of this growth to other parts of the domestic economy especially in the service sectors,
- growth in government expenditure for health and education,
- an active labor policy, and
- immigration -many Irish returned home, an active government policy recruited abroad, and autonomous flows of workers from Eastern European and African countries. It is notable that most of the Irish who returned during the nineties were generally better educated than those that had left Ireland in earlier periods. They brought considerable technical and entrepreneurial skills and fitted in quite well with the demands of the more dynamic economy.

6. Selected Outcomes

6.1 Labor Policy

A study of the labor market by O'Connell (2000) provides some insight on which approaches seem to have given the best results. Expenditures on active labor market programs in Ireland amounted to 1.75 percent of GDP in 1996. Remuneration scales for participants ensured that they had a net gain above their social benefits. His broad finding was, that programs with strong linkages to the labor market were more likely to improve job prospects of participants than those with weak market linkages. These findings held across all age groups. Unfortunately for many of the long-term unemployed, programs with weak market linkages were the only vehicles available. Although public works programs, such as cleaning up canals, had a certain social value, they were not sufficient to significantly improve job prospects for participants. O'Connell's findings suggest that in order to achieve eventual re-integration into the labor market, they would need to progress to schemes tailored to particular needs. For many in the long-term category the objective should be to have them progress to programs with high net placement rates. This in turn may require individual consideration. Some groups, such as single mothers for instance, often face rather specific constraints, such as the need for jobs with flextime to allow them carry out their other responsibilities. The most recent plan, PPF (2001), recognizes the need for a more personalized and consequently more costly approach, to address this need.

6.2 Social Welfare

The high levels of unemployment in the 1980s followed by the relatively successful period of the late 1990s led to significant changes in social expenditures and in particular the implementation of tax and welfare structures.[19] The major thrust of the social partnership has been wage moderation in exchange for tax cuts. The three principal components of current spending on social welfare are education, health and income maintenance or broadly what is termed social security (see O'Riain and O'Connell, 2000).[20] Social welfare has three broad objectives, poverty alleviation, protection of living standards, and redistribution along the life cycle. The Irish welfare state seeks to

[19] For a good exposition see Callan and Nolan (2000).

[20] Historically housing has been an important component of pubic expenditure. In Ireland house ownership has been one of the highest in the world at around 80 percent. Since 1987 a change in policy has resulted in a fall of expenditures on housing from 5 percent of public expenditure in 1987 to 2.5 percent in 1990. For a discussion of this policy change see Fahey and Williams (2000).

provide a basic level of security and service to virtually all residents. At the same time, it also allows those with market-generated advantages to supplement their social citizenship right, with their own resources (O'Connell and Rottman, 1992). Thus it may be termed a pay-related welfare state. Social security has two main schemes; social insurance with contributions from employers, employees and the state; social assistance, with means tested payments for those in old age and unemployment categories. Under the terms of the social partnership accords, the real value of unemployment benefits and assistance payments have been maintained and even increased some since 1987. At the same time the state has spent substantial amounts (1.75 percent of GDP in 1996) on active labor market policies. Thus, while the Irish approach contrasts with the liberal approaches adopted in other European countries, the actual expenditures are lower than most EU countries. In 1987, Ireland spent about 13 percent of GDP on social security but by 1997 this number had dropped to 9 percent. Thus the steady rise in individual payments was more than offset by the buoyant economy.

6.3 Health and Education

Expenditures on education and health follow a similar pattern. In 1967 second level education was made free, and in 1968 means-tested grants for third-level education were introduced so that educational participation increased dramatically in the following decades. In 1985 spending accounted for 6 percent of GDP and then following a drop of about 2.5 percent of over the period 1987-90, real expenditures increased so that by 1997 they were about 50 percent greater. This contributed to the highly skilled work force that helped propel the economic growth of the 1990s.

Expenditures on health throughout the period 1987 to 1997 tended to increase modestly to about 7 percent of GDP, but from lower levels in the 1980s (see Table 1). However, because of the spectacular growth rates they increased by 78 percent in real terms over this period but remain lower than most OECD countries. The basic approach to health care has followed a similar pattern to social security. About one-third of the population has free access to health care, the remainder have access to public hospitals at a modest fee but much of the two-thirds subscribe to private health insurance. Taxation provides for 75 percent of health expenditure. There is some debate about the effectiveness and equity of the overall health system, with long waiting lists for hospital services being a major concern. The situation is further compounded by the demographic pattern as the proportion of older citizens increases.

6.4 *Poverty*

Given the remarkable growth rates in the economy over the 1990s what happened to poverty levels? In terms of conventional measures of purchasing power and income there was a dramatic decline in poverty levels as most people moved up. If one focuses on relative poverty then the situation is more complex. Recent work by Layte and others (2001) suggests that using income at a point in time, especially in an economy experiencing very rapid growth in average incomes, does not give a comprehensive indicator of living standards or poverty. It is important to complement relative income poverty lines with other approaches. They use a number of noneconomic indicators to develop a measure of deprivation.[21] During the 1990s average household real incomes rose rapidly, unemployment fell sharply and social welfare personal rates rose in real terms, but not as much as other incomes. The net effect was numbers on social welfare fell but the remaining recipients fell further behind the average. There have been some changes in the composition of the income and deprivation poverty categories. Within these categories one finds certain dynamic features. The less advantaged classes tend to be the unemployed, the ill/disabled, the retired and those in home duties. Persistent unemployment was more prevalent among the unskilled manual class and those without educational qualifications. The findings seem to confirm the policy orientation of addressing unemployment through an active labor strategy, and a comprehensive education program. If one holds constant in real terms a poverty line then there was a substantial decline in the numbers below that line during the nineties. However in a situation with rapidly rising average incomes societal expectations change and the concept of relative poverty becomes relevant. Using non-monetary indicators of deprivation helps complement income measures to understand poverty and the processes underlying it.

7. Lessons

7.1 *General*

While it is premature to make any unqualified judgment on the Irish experience of the 1990s a number of salient features emerge. While it is not likely any one country can hope to replicate all of the features of the Irish approach, some aspects may offer useful

[21] These measures included three dimensions, basic life-style deprivation, secondary life-style deprivation and housing deprivation. Further details on how these relate to deprivation and social exclusion are given in Layte and others (2000).

ideas for countries that are also facing similar problems to those faced by Ireland in the late 1980s. These included a difficult stabilization problem needing a major fiscal correction, virtually untenable debt/GDP ratio, very high unemployment level, large share of the workforce in agriculture, and a general lack of confidence in the institutions to address the issues. These problems need to be viewed in the overall context of what was happening, in both the global and domestic economy at that time, together with an awareness of specifically Irish characteristics. Historically there has been a relatively low tolerance for social inequity. It is interesting to note that even as overall real incomes increased considerable attention was paid to relative poverty. The extended periods of economic weakness also meant that most were relatively risk averse, although the younger generation was less so. With these considerations in mind, it may be of interest to summarize how Ireland addressed some of the problems that are, unfortunately, common in other countries. A recent piece by Rice and Johnstone (2000) analyzing the economic situation in Scotland was able to identify some of problems that country needed to address by reviewing the Irish experience.

7.2 Macro

Fiscal deficit/social pact. The deficit was "solved " over a brief three-year period by first having the clear support of all major political parties. The objectives were made clear to the public and forceful leadership was applied in the political, fiscal, and social development realms. The strategy involved a social pact having a broad-based coalition of unions, management, and government. Labor basically agreed to wage moderation in return for reduced taxation. The "pain " of the stabilization was made transparent and spread across all groups but with protection for social welfare. For many analysts the adoption of the social pact provided the key to the subsequent virtuous cycle. **This approach ensured that all key groups were aware of the objectives and realized what they were to gain by going along with the measures.**

Exchange rate. The broad policy here was to keep a competitive real rate. When this got out of line with key trading partners the authorities devalued the currency. The EMS offered a certain flexibility. The EMU is expected to have various escape clauses when exceptional circumstances warrant, but will not afford policymakers as much flexibility, thus requiring some innovative thinking on their part.

External debt. The debt-to-GDP ratio in 1987 was around 120 percent. The confidence that ensued from the believable stabilization measures, allowed for favorable interest rates, though initially not quite as low as Deutsche mark rates. There was no early effort to achieve a precipitous reduction in the nominal stock of debt, as the social consensus placed higher priority, in the short term, on other expenditure priorities. **Over time the lower financing needs and high growth rates allowed for a smooth reduction in the debt-to-GDP ratio.**

7.3 European Union

The role of the European union was quite complex. The direct impact of resource transfers was substantial, especially on agriculture, infrastructure and social cohesion. It also provided an institutional umbrella that helped drive the stabilization process and once in place, to galvanize it. This de facto supervision cum incentive structure helped support domestic politicians, who sought greater accountability and transparency in the use of public funds. **While it may not be realistic for many countries to aspire to membership in the EU, the concept of being part of some umbrella group which can provide some form of de facto guidance and appropriate incentives warrants careful consideration.**

7.4 Foreign Direct Investment

The strategy adopted towards FDI helped contribute substantially to the rapid growth of the economy, especially the export sector. A favorable corporate tax regime, supported by double-taxation treaties with the United States and other FDI source countries, together with a well-educated English-speaking labor force, and the large European market were major attractions. The IDA strategy to focus initially on a few high profile multi nationals in the IT and chemical areas was also fortuitous, as their industrial structure lent itself to a certain flexibility, while at the same time the global demand for their output was going through a strong growth phase. Underlying this strategy was the increasing confidence that Ireland would indeed be a reliable bridge to Europe. This was provided by membership in the EU and further reinforced by favorable support of the Maastricht treaty. This in turn led to a favorable investment climate and a change in how companies saw Ireland. Rather than locating relatively simple company offshoots they were now willing to set up more diverse operations and in some instances their European headquarters -a substantial change in the historic approach to FDI.

7.5 Social Welfare

The broad approach was to maintain real levels during the fiscal stabilization. This ensured the less fortunate a basic stipend if unemployed, while free education and health care services were also maintained. Although seemingly obvious, analysis of the poorer groups indicated that unemployment was a key factor.[22] This in turn led to an active labor policy. The more successful policies tended to be focused on the labor market demand. A potent force underlying this success was the expansion of Aggregate Demand. For the long-term unemployed, who lacked adequate education to enter employment focused groups, some preliminary public works programs provided an initial step. For much further progress on the difficult area of addressing the long-term unemployed, it now seems necessary to move to a more personal approach. **As incomes increased a broader range of social/cultural questions arose. A variety of policies were devised to address issues of social exclusion while the whole concept of poverty was extended to include a variety of noneconomic indicators to assess relative poverty.**

7.5 Structural Change.

During the 1990s agriculture declined and the service sector grew. This structural shift occurred in many countries and indeed seems to be an inevitable feature of development. In Ireland the decline in numbers and incomes for the agriculture sector has been cushioned by the large transfers under the CAP scheme, together with a protective wall for European agriculture. At the same time the rest of the economy grew rapidly so that the surplus labor was readily absorbed. At least in the short term, the strategy has been successful in reducing the numbers in agriculture and there has also been some investment in a variety of food-based products. However incomes for those left in agriculture remain low, and pressure from the World Trade Organization is also likely to result in further reductions in supports.

8. Conclusion

The experience of Ireland in the 1990s has been remarkable as it went from being a highly indebted, high unemployment country to a low-debt, low-unemployment country in ten years. Stabilization was achieved in about three years by having a credible political effort with a broad-based social pact. Broad-based support ensured moderate wage increases in exchange for tax concessions together with a guaranteed social welfare package for all. This effort was further consolidated by the broad based institutional umbrella of the European Union, which provided a combination of de facto rules and an array of resource transfers. Growth was achieved by a combination of innovative

[22] This differs somewhat from most of the other European countries where the poorer groups tend to be dominated by retirees.

measures, to attract FDI initially and then a more buoyant domestic demand supported by pari-pasu reductions in the tax burden. Social programs were protected by consensus agreement. Analysis of the poverty situation identified unemployment as a major underlying cause. This was then addressed by an active labor policy.

Is this sustainable? Much of the success is based on external factors. The risks here include the likely decline in resources from the EU, a fall in global demand for exports and a fall in investment by multinationals. Further challenges will result from the potential effects of the entry of Poland/Hungary into the EU. On the domestic side there are a number of emerging constraints on infrastructure, roads, power, housing, while environment concerns are likely to move toward center stage. Policymakers will need to have appropriate responses at hand, to address any downturns in the global economy, while at the same time incorporating sufficient flexibility into the use of domestic resources to meet infrastructure needs. Over the longer term the key economic variables are human resources and investment and of course what kind of society the people want. This requires a keen appreciation of the demographic forces as the population ages and hard choices are made on such areas as distribution, social cohesion and immigration policy. The present education system has served the country well in recent years. On the other hand the health system is in need of upgrading. Both these areas need to be continually upgraded, to meet the population's expectations, and in particular to ensure a healthy labor force with high value skills. Pervading all these policy choices is the issue of the appropriate role for public and private sectors. The approach up until now has been a rather pragmatic one. An important consideration is that in a small domestic economy it may be somewhat unrealistic to expect to have many firms competing in certain sectors. There have been movements to privatize some public entities, while others have been subjected to regulation and supervision. These decisions will become increasingly difficult over time as the authorities come to grips with the need to ensure a competitive economy, and also ensure adequate incentives for investment while maintaining the desired level of social cohesion.

For other countries, especially those in the ASEM group and Latin America, what can be learned?

- Europe is not available to all, but they can devise their own way of embracing some of the advantages it offers. These include the advantage of having an umbrella that provides de facto supervision cum incentive structure. In the Ireland situation this facilitated stable policies together with low interest rates and high growth rates. Certainly the inward transfer of funds that amounted to several percentage points a year, helped in reducing the external debt load and also sustaining investment in infrastructure during the difficult fiscal adjustment. However many other countries have received similar transfers from a variety of sources without achieving very notable results. Even within the EU its Court of Auditors considered the Irish use of funds among the more effective. A more detailed study would help provide useful lessons for other countries and especially those contemplating entry into the EU on the efficient use of transfers.

- FDI success requires administrative capacity and policy stability. These can be built over time. Education can also be strengthened over time. Some of the social and cultural affinities may limit the opportunities for some countries. But again, viewed in the broader context, a winning strategy needs access to markets and the required technology. The EU was an important element of the Irish story. For many countries the EU may not be available but some of the salient features may be. Some degree of confidence in a country's institutions may be achieved if measures are put in place to ensure appropriate guarantees. These might range from acceptable accounting standards to ensuring a fair and equitable legal system. In the Irish case this confidence resulted in some measure from EU membership.
- The social partnership is perhaps the most obvious exportable. The approach to analyzing poverty and unemployment are notable. If a country has to impose fiscal retrenchment much better to do it via cuts in spending than by increasing taxes. In its most pragmatic form it requires that all key groups reach agreement on the direction of policy, and this is reinforced by ensuring that each will gain over time by their support.

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